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No. 430

In the Supreme Court of the United States

OCTOBER TERM, 1946

UNITED STATES OF AMERICA, PETITIONER

v.

OGILVIE HARDWARE COMPANY, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

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The Solicitor General, on behalf of the United States of America, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit, entered May 24, 1946, affirming the judgment of the District Court of the United States for the Western District of Louisiana.

OPINIONS BELOW

The opinion of the District Court (R. 17–25) is reported in 62 F. Supp. 338. The opinion of the Circuit Court of Appeals (R. 34–38) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on May 24, 1946. (R. 38.) The

jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer is entitled to a credit under Section 26 (c) (3) of the Revenue Act of 1936, as added by Section 501 of the Revenue Act of 1942, as a corporation "having a deficit in accumulated earnings and profits," where there is in fact no deficit unless there be subtracted from its earnings and profits the amount of a non-taxable stock dividend which the taxpayer had previously issued.

STATUTES AND OTHER AUTHORITIES INVOLVED

The pertinent provisions of the statutes and other authorities involved are set out in the Appendix, *infra*, pp. 12–19.

STATEMENT

The facts as stipulated (R. 12–17) may be summarized as follows:

The taxpayer, Ogilvie Hardware Company, Inc., was incorporated under the laws of Louisiana in 1907, with a capital stock of 1,000 shares of common stock of the par value of $100,000 issued and outstanding. It operated a wholesale hardware business in that State on a fiscal year basis, ending on May 31, of each year. (R. 12–13.)

The surplus of the corporation at the end of the fiscal year, May 31, 1924, was $149,306.43. On July 7, 1924, a one hundred percent dividend in common stock ($100,000 par value) was issued, share for share, to its common stockholders, which was charged to surplus on the books of the taxpayer during the fiscal year 1925. After charging this dividend to surplus, payment of a cash dividend of $14,681, and giving effect to the earnings for the year ending May 31, 1924, the corporation still had a surplus of $42,229.70. (R. 13.)

Subsequent to the declaration of the stock dividend, the taxpayer sustained operating losses, and on May 31, 1936, its books disclosed a deficit of $74,875.10. On May 31, 1937, the deficit shown on the books was $71,347.18, and on May 31, 1938, the deficit shown was $60,923.58. (R. 14.)

Upon examination of the taxpayer's income and excess profits returns for the fiscal years ending May 31, 1937, and May 31, 1938, the Commissioner of Internal Revenue made certain adjustments and assessed additional taxes, which were paid by the taxpayer. Of the total taxes paid by the taxpayer for those periods, $5,426.93 consisted of a surtax on undistributed profits for the fiscal year 1937, and $1,488.86 consisted of a surtax on undistributed profits for the fiscal year 1938. (R. 15, 16.)

Following the enactment of Section 501 of the Revenue Act of 1942, the taxpayer filed claims for refund of the surtax on undistributed profits in the amounts of $5,426.93 and $1,488.86, for the fiscal years 1937 and 1938, respectively, based on the ground that it had a continuous "deficit" in accumulated earnings and profits on May 31, 1936, May 31, 1937, and May 31, 1938, which on each of those dates exceeded the total amount of its net income for the fiscal years ending with those dates and that it was thus prohibited by Louisiana law from paying dividends to its stockholders. The Commissioner rejected the claims and thereafter the present suit was instituted to recover these amounts. (R. 16–17.)

The District Court entered a judgment in favor of the taxpayer for the amount in suit (R. 27–28), and the Circuit Court of Appeals affirmed (R. 38).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that the taxpayer is entitled to a credit as a corporation having a deficit in accumulated earnings and profits within the meaning of Section 26 (c) (3) of the Revenue Act of 1936, as added by Section 501 of the Revenue Act of 1942.

(2) In holding that state law is controlling in the determination of whether a corporation is a

deficit corporation within the meaning of these provisions of the federal statute.

(3) In holding that the report of the Senate Committee on Finance may not be resorted to as an aid in interpreting the statute.

(4) In holding invalid the pertinent provision of the Treasury Regulations.

(5) In holding that the 1924 stock dividend irrevocably took $100,000 out of distributable earnings and profits, or surplus, and converted it to capital for federal tax purposes.

(6) In affirming the judgment of the District Court.

REASONS FOR GRANTING THE WRIT

1. The decision of the court below in the present case is in conflict with the decision of the Circuit Court of Appeals for the Eighth Circuit in *Century Electric Co.* v. *Commissioner,* 144 F. 2d 983, which affirmed a decision of the Tax Court reported in 3 T. C. 297.

In that case, as in the present case, the question was whether the taxpayer in computing the surtax upon undistributed profits was entitled to a credit under Section 26 (c) (3) of the Revenue Act of 1936, as added by Section 501 of the Revenue Act of 1942, Appendix, *infra,* p. 12, as a corporation having a deficit in its accumulated earnings and profits where the book deficit would

not have existed except for the prior issuance by the taxpayer of a nontaxable stock dividend.

Section 26 (c) (3), as amended, provides for a credit "In the case of a corporation having a deficit in accumulated earnings and profits" if the corporation is prohibited by local law from paying dividends "during the existence of a deficit in accumulated earnings and profits."

In *Century Electric Co.* v. *Commissioner, supra,* the taxpayer contended that the meaning of "a corporation having a deficit in accumulated earnings and profits" appearing in Section 26 (c) (3) should be determined by state law and that under the state law applicable in that case, the issuance of the stock dividends resulted in a capitalization of earnings and profits and thereby effected a reduction thereof in an amount equal to the par value of the stock issued as stock dividends. Both the Tax Court and the Circuit Court of Appeals held, however, that federal law rather than state law controlled in the determination of this question, and the conclusion was reached that Section 115 (h) of the Revenue Act of 1936, Appendix, *infra,* pp. 12–13, declaring the distribution of nontaxable stock dividends should not be considered a distribution of earnings or profits of any corporation, precluded the reduction of the earnings and profits of a corporation on account of such nontaxable stock dividend so as to create a deficit

under Section 26 (c) (3) for which credit is given by that section.

In the present case, the court below held that the deficit referred to in Section 26 (c) (3) is that which the state law denominates as a deficit in prohibiting the payment of dividends, and the court accordingly held that Section 115 (h) of the Revenue Act of 1936 has no bearing on Section 26 (c) (3), as amended. Resorting to state law nomenclature, the court below held that the $100,000 represented by the 1924 stock dividend was, from the corporate standpoint, irrevocably taken out of the surplus earnings and profits and converted to capital, that the deficit was thus caused by subsequent operating losses, and that the taxpayer was entitled to the claimed credit.

The court below, although apparently recognizing a conflict between its decision and that in *Century Electric Co.* v. *Commissioner* (R. 35), stated that it *might* agree (R. 38) that the taxpayer could not secure the credit if the deficit had been caused directly by a stock dividend. In the *Century Electric Co.* case, however, as in the present case, the taxpayer's books had a credit balance in the surplus account after declaration of the stock dividend. In both that case and the present case the deficit would exist only by treating the stock dividend as diminishing the accumulated earnings and profits. There is, we submit, no adequate ground for distinguishing that case

from the present case. Because of the conflict, this is clearly an appropriate decision for this Court to review.

2. In reaching the result it did, the court below rejected the applicable Treasury Regulations as well as an unambiguous report of the Senate Committee on Finance. Indeed, the opportunity for ambiguity had been virtually eliminated by an "example" in the committee report showing the operation of the statute (S. Rep. No. 1631, Appendix, *infra*, pp. 17–19):

> Assume in the above example[1] that the deficit in accumulated earnings and profits is $20,000 for income tax purposes, but the deficit in accumulated earnings and profits on the corporation's books by reason of a prior capitalization of surplus in the course of a nontaxable reorganization amounts to $250,000. In this case, although the State law would probably prohibit payment of any dividends, the credit allowed under the amendment to section 26 (c) is limited to $20,000, which is the deficit in accumulated earnings and profits for income tax purposes. X corporation, therefore, will be liable for undistributed profits surtax on $180,000 of its adjusted net income.

This example is also contained in Article 26–2 of Treasury Regulations 94, as amended (Appendix, *infra*, pp. 15–17).

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[1] The "above example" referred to X corporation which had an adjusted net income of $200,000.

In refusing to give any weight to the example, the court employed a technique of statutory construction that is plainly at variance with the current of decision in this Court. Compare, e. g., *Harrison* v. *Northern Trust Co.*, 317 U. S. 476. The court below was at pains to point out the basis for disregarding the committee report and regulations in the following analysis of the legislative process (R. 37):

> It [the example] is merely the opinion of the writer of the report on how the legislation would work out in the case of a nontaxable reorganization. The Constitution, Article 1, Section 7, states how the laws of the United States are made: by written Bill, passed by the House and Senate separately, transmitted to the President and approved by him, or passed over his veto. The provision is express that thus "the same [the Bill] shall be a Law". The report of a Committee of the Senate is not voted on—perhaps not read by—the members even of the Senate; but the words of the Bill are. The Bill is transmitted to the House, and it—not the Committee's report—is passed there. The Bill is then sent to the President for his approval. He does not approve a Committee report, if by any chance he should see it. He approves the words of the Bill and it becomes the law. Under the statutes on the subject the Bill as soon as passed by either House is printed and becomes the authentic Bill: 1 U. S.

C. A. § 26. On final passage and printing, 44 U. S. C. A. § 196, the printed Acts are evidence of the laws passed; 1 U. S. C. A. § 30. The words of the Act are the law. Only when the words of the law are difficult of understanding can what happened in passing it be resorted to for aid. Its clear meaning cannot be so altered. Nor can anything be thus added to it. Nor can putting an example into the Regulation add to or change the law as passed.

It is a matter of general importance that the administration of the revenue laws be protected against judicial interference by means of such statutory construction, where the intent of Congress is so clearly set forth in the committee reports, where the Treasury regulations plainly establish the administrative practice, and where the Tax Court has approved that practice.[2]

3. Although the undistributed profits tax, here involved, has been repealed, the question presented is nevertheless very much alive in cases pending in the District Courts within the Third, Fifth, Sixth, Seventh and Tenth Circuits, involving substantial amounts of revenue. It is in the interest of consistent administration of the tax laws that the issue be authoritatively set at rest by this Court.

Upon somewhat different reasoning, the court below arrived at the same result here as was

[2] See *Century Electric Co.* v. *Commissioner*, 3 T. C. 297.

reached in *United States* v. *Byron Sash & Door Co.*, 150 F. 2d 44 (C. C. A. 6). The Government did not apply for certiorari in that case because of the small amount there involved and because it was hoped that other courts[2] would not follow it since it seemed so plainly wrong; and the latter reason seemed particularly cogent in view of this Court's treatment of a similar situation in *Commissioner* v. *Estate of Bedford*, 325 U. S. 283. However, the decision in the present case demonstrates that there is an irreconcilable conflict among the circuits, and it is in the public interest that the issue be settled.

CONCLUSION

For the reasons stated it is respectfully submitted that the petition for a writ of certiorari should be granted.

J. HOWARD MCGRATH,
Solicitor General.

AUGUST 1946.

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[2] See the later decision of the Sixth Circuit in *Long* v. *Commissioner*, decided May 11, 1946 (1946 C. C. H., par. 9271), for that court's views generally on the effect of the distribution of a nontaxable stock dividend.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) [As amended by Section 501 of the Revenue Act of 1942, c. 619, 56 Stat. 798.] *Restrictions on Payment of Dividends*—

* * * * *

(3) *Deficit corporations.*—In the case of a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year, the amount of such deficit, if the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * *

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a dis-

tribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

Louisiana Acts (1928), Act No. 250:

SECTION 26. DIVIDENDS: METHOD OF ESTIMATING FUND FOR PAYMENT OF.

I. No corporation shall pay dividends in cash or property,

(a) except from the surplus of the aggregate of its assets over the aggregate of its liabilities, plus the amount of its capital stock; or

(b) out of any surplus due or arising from—

(1) any profit on treasury shares before resale; or

(2) any unrealized appreciation in value or revaluation of fixed assets; or

(3) any unrealized appreciation in value or revaluation of inventories before sale; or

(4) the unaccrued portion of unrealized profit on notes, bonds or obligations for the payment of money, purchased or other-

wise acquired, unless such notes, bonds or obligations are readily marketable, in which case they may be taken at their actual market value; or

(5) the unaccrued or unearned portion of any unrealized profit in any form whatever, whether in the form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise, except as provided in the preceding subparagraph (4).

II. In case all or any part of any cash dividend is paid out of paid-in surplus, the shareholders shall at the time of payment be notified of that fact.

III. No corporation shall pay dividends in shares of the corporation, except from the surplus of the aggregate of its assets, which, for this purpose only, may include items mentioned in Subdivision I (b), over the aggregate of its liabilities, plus the amount of its capital stock.

IV. In computing the aggregate of the assets of the corporation, for the purpose of dividends, whether payable in cash, property or shares, proper allowance shall be made for depreciation and depletion sustained, and ascertained or known losses of every character. Deferred assets and prepaid expenses shall be considered as assets only to the amounts not used or not accrued.

V. Subject to the limitations contained in this Section, a dividend may be declared in shares of the corporation, whenever the board of directors so determine, provided that

(a) if the dividend is to be paid in shares having a par value, the aggregate par value of such shares shall not exceed the amount

of that portion of the corporation's surplus which is transferred to capital as payment for such shares;

(b) if the dividend is paid in shares having no par value, the number of such shares shall be fixed by the board of directors;

(c) no dividend payable in shares of any class shall be paid to shareholders of any other class, unless the articles so provide, or such payment is authorized by the vote of the holders of a majority of the shares of the class in which the payment is to be made.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26–2. [As amended by T. D. 5263, 1943 Cum. Bull. 1003.] *Credit in Connection With Restrictions on Payment of Dividends.*—

* * * * *

(d) ***Deficit corporations.***—Under the provisions of section 26 (c) (3), a corporation having a deficit in accumulated earnings and profits as of the close of the preceding taxable year is allowed as a credit the amount of such deficit to the extent that the corporation is prohibited by a provision of a law or of an order of a public regulatory body from paying dividends during the existence of a deficit in accumulated earnings and profits, and if such provision was in effect prior to May 1, 1936.

Whether such a deficit exists as of the close of the preceding taxable year is a question to be determined from the facts and circumstances of each particular case. In any such case the taxpayer must show

how the deficit arose, whether from operating losses, capital distributions in excess of earnings and profits, or other causes. In addition the taxpayer must show, under a law or an order of a public regulatory body, the extent to which it could not legally have paid dividends during the existence of such deficit. A State law, for example, might permit the payment of a dividend from unrealized appreciation in value of assets even though the corporation had a deficit in accumulated earnings and profits. A deficit in accumulated earnings and profits can arise only out of the operation of the business at a loss and can not be caused by distributions to shareholders in excess of the amount of accumulated earnings and profits. If distributions are made to shareholders out of accumulated earnings and profits, however, such distributions may contribute to the creation of a deficit by so exhausting the accumulated earnings and profits that they are incapable of absorbing a loss thereafter resulting from the business. Unrealized appreciation or depreciation in value of assets is not a factor in determining accumulated earnings and profits.

The application of the provisions of section 26 (c) (3) may be illustrated by the following examples:

Example (1).—The M Corporation for the calendar year 1936 had an adjusted net income of $200,000 but had an actual deficit in accumulated earnings and profits as of December 31, 1935, of $20,000. By reason of a State law in effect prior to May 1, 1936, with respect to deficit corporations, the M Corporation was prohibited from paying dividends during the existence of

such deficit. Under section 26 (c) (3), the M Corporation is allowed a credit of $20,000.

Example (2).—Assume in the above example that the deficit in the accumulated earnings and profits is $20,000 for income tax purposes, but the deficit on the corporation's books by reason of a priof capitalization of surplus in the course of a nontaxable reorganization amounts to $250,000. In this case, even though the State law might prevent the distribution of any dividends, the credit under section 26 (c) (3) is limited to $20,000, which is the deficit in accumulated earnings and profits for income tax purposes.

* * * * * * *

S. Rep. 1631, 77th Cong., 2d Sess., pp. 244–246 (1942–2 Cum. Bull. 504, 683–684):

SECTION 501. ADDITIONAL CREDITS FOR UNDISTRIBUTED PROFITS TAX.

This section is the same as in the House bill, except that a new paragraph to section 26 (c) has been added, providing for an additional credit in cases of corporations having a deficit in accumulated earnings and profits and prohibited by law from paying dividends, and except that a new subsection has been added providing for a stock redemption credit.

* * * * * *

Under section 14 of the Revenue Act of 1936 corporations in general were subject to surtax at various rates from 7 to 27 percent of their undistributed net income. In some instances State law or an order of a public regulatory body prohibited payment of dividends during the existence of a deficit even though the corporation had cur-

rent earnings and profits which would constitute undistributed net income under the definition thereof in section 14 (a) (2). Such corporations were, therefore, subject to undistributed profits surtax even though they were prohibited by law from paying dividends. The addition of the new paragraph 3 to subsection (c) of section 26 to provide an additional credit in the amount of the deficit in accumulated earnings and profits as of the close of the preceding taxable year is intended to give relief in certain of these cases.

* * * * * *

The application of the deficit credits provided by these amendments may be illustrated by the following examples:

(1). The X corporation for the calendar year 1936 had an adjusted net income of $200,000 but had a deficit in accumulated earnings and profits as of the close of the preceding calendar year of $20,000. By reason of a State law in effect prior to May 1, 1936. with respect to deficit corporations, only $180,000 of this adjusted net income could be distributed as dividends. Under section 14 of the Revenue Act of 1936, X corporation would be subject to undistributed-profits surtax on $20,000 even though it paid out the entire amount which it could have distributed without violating the State law—namely, $180,000, as taxable dividends. Under the amendment to section 26 (c), X corporation would be allowed a credit of $20,000, and would not be liable for any undistributed-profits tax for the calendar year 1936.

(2) Assume in the above example that the deficit in accumulated earnings and profits is $20,000 for income tax purposes,

but the deficit in accumulated earnings and profits on the corporation's books by reason of a prior capitalization of surplus in the course of a nontaxable reorganization amounts to $250,000. In this case, although the State law would probably prohibit payment of any dividends, the credit allowed under the amendment to section 26 (c) is limited to $20,000, which is the deficit in accumulated earnings and profits for income tax purposes. X corporation, therefore, will be liable for undistributed profits surtax on $180,000 of its adjusted net income.

* * * * *

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